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What are Build America Bonds or Direct-Pay Municipal Bonds?

Interest on many municipal bonds issued by local and state governments and some non-profits is exempt from federal income taxes. As a result, investors, mainly high-income individuals, are willing to lend money to issuers at a lower interest rate than they would demand if the bonds were taxable. Build America Bonds (known as BABs or direct-pay bonds) were created by the American Recovery and Reinvestment Act of 2009 as an alternative way for the federal government to subsidize local and state government borrowing. Instead of making the interest on those bonds exempt from federal income taxes, the federal government provided a subsidy directly.

The BABs program ended in 2010, but the concept has been part of the 2021 debate over financing increased federal infrastructure spending. Here is a primer on these bonds.

HOW DID BABS WORK?

Because the interest investors earn on municipal bonds is generally exempt from federal income taxes, an investor in the top income tax bracket can earn the same after-tax return on a lower-yielding municipal bond as on a higher-yielding taxable bond. For example, for an investor in the top tax bracket, the after-tax return on a 1.3% tax-exempt bond is the same as on a 2.15% taxable bond.

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